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Enhancing understanding of sophisticated planning strategies and their applications.

Section 162 Executive Bonus Plans

What is a 162 Executive Bonus Plan?

A 162 Executive Bonus plan allows a business to provide life and/or disability income insurance to key executives using tax deductible dollars.

Insurance policies are owned by the executives and are paid for through cash bonuses to the executives. In practice, the business may actually pay the premiums directly to the insurance company, then include the amounts in the executives' reported W-2 income.

The executive has all of the ownership rights of the policy, including the right to name his or her own beneficiary(ies) and to access the policy cash values (except when a Restricted Executive Bonus Arrangement is used, as explained below).

Benefits to the Business/Employer

- The plan requires no administration costs, IRS approval, or complicated government reporting.
- Provides a powerful means to attract, motivate, and retain quality employees.
- May be provided on a selective basis, allowing the employer to choose specific employees to participate.
- Benefit amounts may be varied among participants.

Benefits to the Executive

- The executive is the owner of the policy with full rights to the policy and any policy cash values (possibly subject to a REBA, described below).
- The bonus plan frees up personal funds that would otherwise be spent for personal life insurance needs.

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Single vs. Double Bonus

In a “Single Bonus” design, the executive is responsible for paying the taxes on the premium amounts paid (either directly or indirectly) by the employer.

In a “Double Bonus” design, the employer pays the premium amount, and provides a cash sum to the executive to cover the tax on the premium amount. This makes the entire bonus effectively tax-free to the executive.

Restricted Executive Bonus Arrangement

If cash value life insurance is used, a Restricted Executive Bonus Arrangement (REBA) may be incorporated into the plan. The REBA prevents the executive from accessing the policies cash values without the consent of the employer.¹

Employers often use this approach as a device to retain key employees. The employer usually develops a written agreement with the executive that defines specific “qualifying” events that will trigger the release of the executive from the agreement. For example, the REBA may be terminated in the event of the executive’s death, disability, or retirement, or after a specified period of time such as 10 years. This technique creates a sort of golden handcuffs providing incentive to the executive to remain with the business.

Taxation

- Bonused amounts are tax deductible to the business if the bonuses are considered reasonable compensation.²
- Executives will owe income tax on the bonused amount when the bonus is received.
- Death benefits are generally received by the executive’s beneficiary(ies) free of income tax.³
- Life insurance will be includible in the executive’s estate if the executive retains incidents of ownership in the policy.

Considerations

- Though it is not required, it is recommended that a written plan be developed—primarily because it helps to avoid disallowance of the employer’s deduction on the grounds that a bonus is unreasonable.
- While there are no maximum or minimum requirements for the amount of the bonus, certain premium amounts may be necessary to help ensure the life insurance policy meets the desired objectives.

1. The insurance company typically provides a Controlled Executive Bonus Agreement form that spells out the circumstances under which policy cash values may be accessed. The insurance company is not a party to the REBA, and will typically only follow instructions it has been given allowing or prohibiting access to cash values.

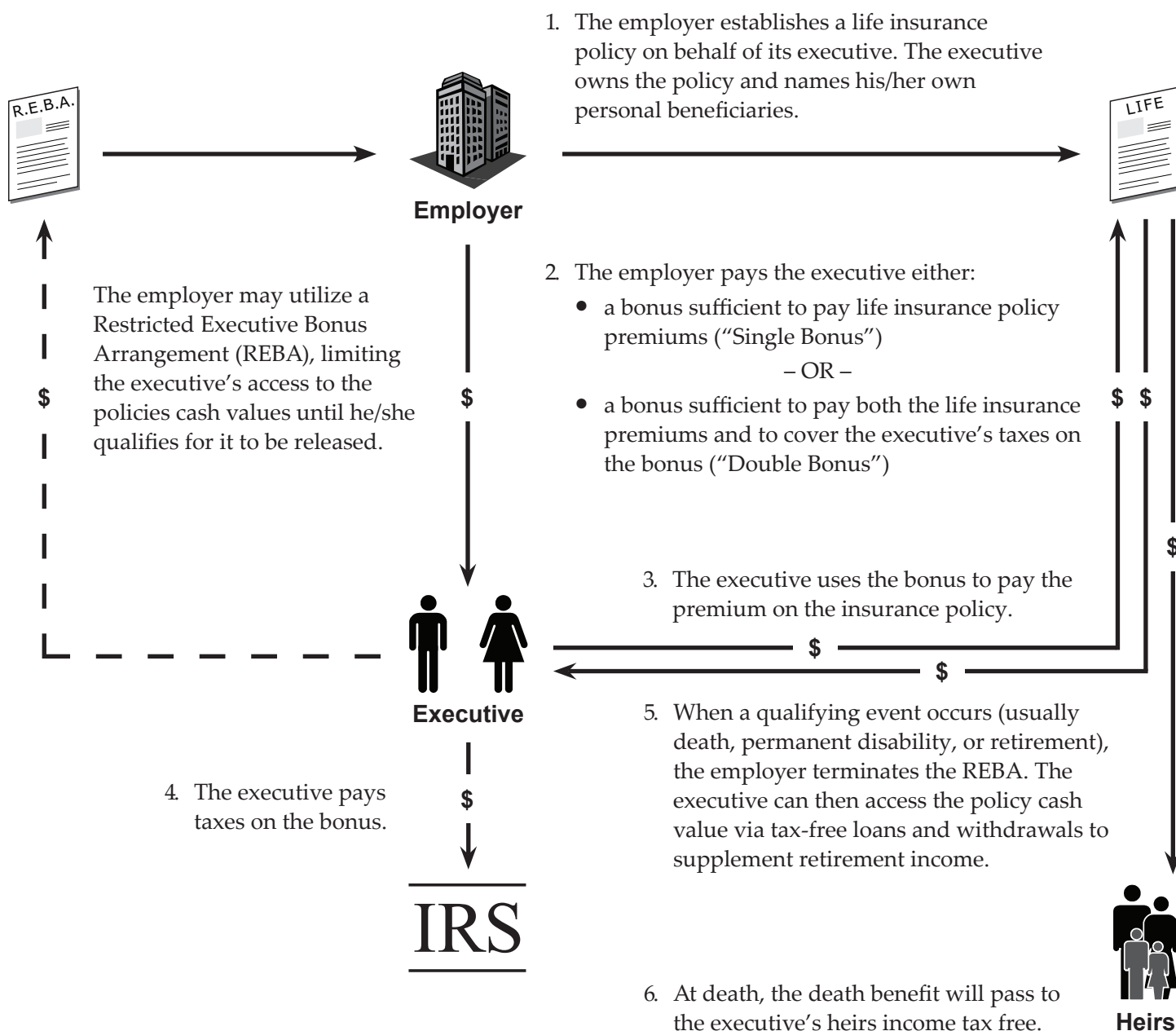
2. Internal Revenue Code Section 162(a)(1).

3. Internal Revenue Code Section 101(a).

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Section 162 Executive Bonus Plan with a Restrictive Executive Bonus Arrangement (REBA)



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